

**§ 206.178 Processing allowances—general.**

(a) Where the value of gas is determined pursuant to § 206.173 of this subpart, a deduction shall be allowed for the reasonable actual costs of processing.

(b) Processing costs must be allocated among the gas plant products. A separate processing allowance must be determined for each gas plant product and processing plant relationship. Natural gas liquids (NGL's) shall be considered as one product.

(c)(1) Except as provided in paragraph (d)(2) of this section, the processing allowance shall not be applied against the value of the residue gas. Where there is no residue gas MMS may designate an appropriate gas plant product against which no allowance may be applied.

(2) Except as provided in paragraph (c)(3) of this section, the processing allowance deduction on the basis of an individual product shall not exceed 66% percent of the value of each gas plant product determined in accordance with § 206.173 of this subpart (such value to be reduced first for any transportation allowances related to postprocessing transportation authorized by § 206.176 of this subpart).

(3) Upon request of a lessee, MMS may approve a processing allowance in excess of the limitation prescribed by paragraph (c)(2) of this section. The lessee must demonstrate that the processing costs incurred in excess of the limitation prescribed in paragraph (c)(2) of this section were reasonable, actual, and necessary. An application for exception (using Form MMS-4393, Request to Exceed Regulatory Allowance Limitation) shall contain all relevant and supporting documentation for MMS to make a determination. Under no circumstances shall the value for royalty purposes of any gas plant product be reduced to zero.

(d)(1) Except as provided in paragraph (d)(2) of this section, no processing cost deduction shall be allowed for the costs of placing lease products in marketable condition, including dehydration, separation, compression, or storage, even if those functions are performed off the lease or at a processing plant. Where gas is processed for the

removal of acid gases, commonly referred to as "sweetening," no processing cost deduction shall be allowed for such costs unless the acid gases removed are further processed into a gas plant product. In such event, the lessee shall be eligible for a processing allowance as determined in accordance with this subpart. However, MMS will not grant any processing allowance for processing lease production which is not royalty bearing.

(2)(i) If the lessee incurs extraordinary costs for processing gas production from a gas production operation, it may apply to MMS for an allowance for those costs which shall be in addition to any other processing allowance to which the lessee is entitled pursuant to this section. Such an allowance may be granted only if the lessee can demonstrate that the costs are, by reference to standard industry conditions and practice, extraordinary, unusual, or unconventional.

(ii) Prior MMS approval to continue an extraordinary processing cost allowance is not required. However, to retain the authority to deduct the allowance the lessee must report the deduction to MMS in a form and manner prescribed by MMS.

(e) If MMS determines that a lessee has improperly determined a processing allowance authorized by this subpart, then the lessee shall pay any additional royalties, plus interest determined in accordance with 30 CFR 218.54, or shall be entitled to a credit, without interest.

**§ 206.179 Determination of processing allowances.**

(a) *Arm's-length processing contracts.*

(1)(i) For processing costs incurred by a lessee pursuant to an arm's-length contract, the processing allowance shall be the reasonable actual costs incurred by the lessee for processing the gas pursuant to that contract, except as provided in paragraphs (a)(1)(ii) and (a)(1)(iii) of this section, subject to monitoring, review, audit, and adjustment. The lessee shall have the burden of demonstrating that its contract is arm's-length. Before any deduction may be taken, the lessee must submit a completed page one of Form MMS-

4109, Gas Processing Allowance Summary Report, in accordance with paragraph (c)(1) of this section. A processing allowance may be claimed retroactively for a period of not more than 3 months prior to the first day of the month that Form MMS-4109 is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee.

(ii) In conducting reviews and audits, MMS will examine whether the contract reflects more than the consideration actually transferred either directly or indirectly from the lessee to the processor for the processing. If the contract reflects more than the total consideration, then MMS may require that the processing allowance be determined in accordance with paragraph (b) of this section.

(iii) If MMS determines that the consideration paid pursuant to an arm's-length processing contract does not reflect the reasonable value of the processing because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and lessor, then MMS shall require that the processing allowance be determined in accordance with paragraph (b) of this section. When MMS determines that the value of the processing may be unreasonable, MMS will notify the lessee and give the lessee an opportunity to provide written information justifying the lessee's processing costs.

(2) If an arm's-length processing contract includes more than one gas plant product and the processing costs attributable to each product can be determined from the contract, then the processing costs for each gas plant product shall be determined in accordance with the contract. No allowance may be taken for the costs of processing lease production which is not royalty-bearing.

(3) If an arm's-length processing contract includes more than one gas plant product and the processing costs attributable to each product cannot be determined from the contract, the lessee shall propose an allocation procedure to MMS. The lessee may use its proposed allocation procedure until

MMS issues its determination. The lessee shall submit all relevant data to support its proposal. The initial proposal must be submitted by June 30, 1988 or within 3 months after the last day of the month for which the lessee requests a processing allowance, whichever is later (unless MMS approves a longer period). MMS shall then determine the processing allowance based upon the lessee's proposal and any additional information MMS deems necessary. No processing allowance will be granted for the costs of processing lease production which is not royalty bearing.

(4) Where the lessee's payments for processing pursuant to an arm's-length contract are not based on a dollar per unit basis, the lessee shall convert whatever consideration is paid to a dollar value equivalent for the purposes of this section.

(b) *Non-arm's-length or no contract.* (1) If a lessee has a non-arm's-length processing contract or has no contract, including those situations where the lessee performs processing for itself, the processing allowance will be based upon the lessee's reasonable actual costs as provided in this paragraph. All processing allowances deducted pursuant to a non-arm's-length or no contract situation are subject to monitoring, review, audit, and adjustment. Before any estimated or actual deduction may be taken, the lessee must submit a completed Form MMS-4109 in accordance with paragraph (c)(2) of this section. A processing allowance may be claimed retroactively for a period of not more than 3 months prior to the first day of the month that Form MMS-4109 is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee. MMS will monitor the allowance deduction to ensure that deductions are reasonable and allowable. When necessary or appropriate, MMS may direct a lessee to modify its actual processing allowance.

(2) The processing allowance for non-arm's-length or no contract situations shall be based upon the lessee's actual costs for processing during the reporting period, including operating and maintenance expenses, overhead, and either depreciation and a return on

undepreciated capital investment in accordance with paragraph (b)(2)(iv)(A) of this section, or a cost equal to the initial depreciable investment in the processing plant multiplied by a rate of return in accordance with paragraph (b)(2)(iv)(B) of this section. Allowable capital costs are generally those costs for depreciable fixed assets (including costs of delivery and installation of capital equipment) which are an integral part of the processing plant.

(i) Allowable operating expenses include: Operations supervision and engineering; operations labor; fuel; utilities; materials; ad valorem property taxes; rent; supplies; and any other directly allocable and attributable operating expense which the lessee can document.

(ii) Allowable maintenance expenses include: maintenance of the processing plant; maintenance of equipment; maintenance labor; and other directly allocable and attributable maintenance expenses which the lessee can document.

(iii) Overhead directly attributable and allocable to the operation and maintenance of the processing plant is an allowable expense. State and Federal income taxes and severance taxes, including royalties, are not allowable expenses.

(iv) A lessee may use either depreciation or a return on depreciable capital investment. When a lessee has elected to use either method for a processing plant, the lessee may not later elect to change to the other alternative without approval of MMS.

(A) To compute depreciation, the lessee may elect to use either a straight-line depreciation method based on the life of equipment or on the life of the reserves which the processing plant services, or a unit-of-production method. After an election is made, the lessee may not change methods without MMS approval. A change in ownership of a processing plant shall not alter the depreciation schedule established by the original processor/lessee for purposes of the allowance calculation. With or without a change in ownership, a processing plant shall be depreciated only once. Equipment shall not be depreciated below a reasonable salvage value.

(B) MMS shall allow as a cost an amount equal to the allowable initial capital investment in the processing plant multiplied by the rate of return determined pursuant to paragraph (b)(2)(v) of this section. No allowance shall be provided for depreciation. This alternative shall apply only to plants first placed in service after March 1, 1988.

(v) The rate of return shall be the industrial rate associated with Standard and Poor's BBB rating. The rate of return shall be the monthly average rate as published in Standard and Poor's Bond Guide for the first month of the reporting period for which the allowance is applicable and shall be effective during the reporting period. The rate shall be redetermined at the beginning of each subsequent processing allowance reporting period (which is determined pursuant to paragraph (c)(2) of this section).

(3) The processing allowance for each gas plant product shall be determined based on the lessee's reasonable and actual cost of processing the gas. Allocation of costs to each gas plant product shall be based upon generally accepted accounting principles. The lessee may not take an allowance for the costs of processing lease production which is not royalty bearing.

(4) A lessee may apply to MMS for an exception from the requirement that it compute actual costs in accordance with paragraphs (b)(1) through (b)(3) of this section. MMS may grant the exception only if: (i) The lessee has arm's-length contracts for processing other gas production at the same processing plant; and (ii) at least 50 percent of the gas processed annually at the plant is processed pursuant to arm's-length processing contracts; if MMS grants the exception, the lessee shall use as its processing allowance the volume weighted average prices charged other persons pursuant to arm's-length contracts for processing at the same plant.

(c) *Reporting requirements.* (1) *Arm's-length contracts.* (i) With the exception of those processing allowances specified in paragraphs (c)(1)(v) and (c)(1)(vi) of this section, the lessee shall submit page one of the initial Form MMS-4109 (and Schedule 1) prior to the time, or

at the same time as, the processing allowance determined pursuant to an arm's-length contract is reported on Form MMS-2014, Report of Sales and Royalty Remittance. A Form MMS-4109 received by the end of the month that the Form MMS-2014 is due shall be considered to be timely received.

(ii) The initial Form MMS-4109 shall be effective for a reporting period beginning the month that the lessee is first authorized to deduct a processing allowance and shall continue until the end of the calendar year, or until the applicable contract or rate terminates or is modified or amended, whichever is earlier.

(iii) After the initial reporting period and for succeeding reporting periods, lessees must submit page 1 of Form MMS-4109 (and Schedule 1) within 3 months after the end of the calendar year, or after the applicable contract or rate terminates or is modified or amended, whichever is earlier, unless MMS approves a longer period (during which period the lessee shall continue to use the allowance from the previous reporting period).

(iv) MMS may require that a lessee submit arm's-length processing contracts and related documents. Documents shall be submitted within a reasonable time, as determined by MMS.

(v) Processing allowances which are based on arm's-length contracts and which are in effect at the time these regulations become effective will be allowed to continue until such allowances terminate. For the purpose of this section, only those allowances that have been approved by MMS in writing shall qualify as being in effect at the time these regulations became effective.

(vi) MMS may establish, in appropriate circumstances, reporting requirements which are different from the requirements of this section.

(2) *Non-arm's-length or no contract.* (i) With the exception of those processing allowances specified in paragraphs (c)(2)(v), (c)(2)(vii) and (c)(2)(viii) of this section, the lessee shall submit an initial Form MMS-4109 prior to, or at the same time as, the processing allowance determined pursuant to a non-arm's-length contract or no contract situation is reported on Form MMS-

2014, Report of Sales and Royalty Remittance. A Form MMS-4109 received by the end of the month that the Form MMS-2014 is due shall be considered to be timely received. The initial report may be based upon estimated costs.

(ii) The initial Form MMS-4109 shall be effective for a reporting period beginning the month that the lessee first is authorized to deduct a processing allowance and shall continue until the end of the calendar year, or until the processing pursuant to the non-arm's-length contract or the no contract situation terminates, whichever is earlier.

(iii) For calendar-year reporting periods succeeding the initial reporting period, the lessee shall submit a completed Form MMS-4109 containing the actual costs for the previous reporting period. If gas processing is continuing, the lessee shall include on Form MMS-4109 its estimated costs for the next calendar year. The estimated gas processing allowance shall be based on the actual costs for the previous period plus or minus any adjustments which are based on the lessee's knowledge of decreases or increases which will affect the allowance. Form MMS-4109 must be received by MMS within 3 months after the end of the previous reporting period, unless MMS approves a longer period (during which period the lessee shall continue to use the allowance from the previous reporting period).

(iv) For new processing plants, the lessee's initial Form MMS-4109 shall include estimates of the allowable gas processing costs for the applicable period. Cost estimates shall be based upon the most recently available operations data for the plant, or if such data are not available, the lessee shall use estimates based upon industry data for similar gas processing plants.

(v) Processing allowances based on non-arm's-length or no contract situations which are in effect at the time these regulations become effective will be allowed to continue until such allowances terminate for gas production from Indian leases. For the purposes of this section, only those allowances that have been approved by MMS in writing shall qualify as being in effect at the time these regulations become effective.

(vi) Upon request by MMS, the lessee shall submit all data used by the lessee to prepare its Form MMS-4109. The data shall be provided within a reasonable period of time, as determined by MMS.

(vii) MMS may establish, in appropriate circumstances, reporting requirements which are different from the requirements of this section.

(viii) If the lessee is authorized to use the volume weighted average prices charged other persons as its processing allowance in accordance with paragraph (b)(4) of this section, it shall follow the reporting requirements of paragraph (c)(1) of this section.

(3) MMS may establish reporting dates for individual leases different from those specified in this subpart in order to provide more effective administration. Lessees will be notified of any change in their reporting period.

(4) Processing allowances must be reported as a separate line on the Form MMS-2014, unless MMS approves a different reporting procedure.

(d) *Interest assessments for incorrect or late reports and failure to report.* (1) If a lessee deducts a processing allowance on its Form MMS-2014 without complying with the requirements of this section, the lessee shall pay interest only on the amount of such deduction until the requirements of this section are complied with. The lessee also shall repay the amount of any allowance which is disallowed by this section.

(2) If a lessee erroneously reports a processing allowance which results in an underpayment of royalties, interest shall be paid on the amount of that underpayment.

(3) Interest required to be paid by this section shall be determined in accordance with 30 CFR 218.54.

(e) *Adjustments.* (1) If the actual gas processing allowance is less than the amount the lessee has taken on Form MMS-2014 for each month during the allowance form reporting period, the lessee shall be required to pay additional royalties due plus interest computed pursuant to 30 CFR 218.54, retroactive to the first day of the first month the lessee is authorized to deduct a processing allowance. If the actual processing allowance is greater than the amount the lessee has taken

on Form MMS-2014 for each month during the allowance period, the lessee shall be entitled to a credit, without interest.

(2) For lessees processing production from onshore Indian leases, the lessee must submit a corrected Form MMS-2014 to reflect actual costs, together with any payment, in accordance with instructions provided by MMS.

(f) *Other processing cost determinations.* The provisions of this section shall apply to determine processing costs when establishing value using a net back valuation procedure or any other procedure that requires deduction of processing costs.

### Subpart F—Federal Coal

SOURCE: 54 FR 1523, Jan. 13, 1989, unless otherwise noted.

#### § 206.250 Purpose and scope.

(a) This subpart is applicable to all coal produced from Federal coal leases. The purpose of this subpart is to establish the value of coal produced for royalty purposes, of all coal from Federal leases consistent with the mineral leasing laws, other applicable laws and lease terms.

(b) If the specific provisions of any statute or settlement agreement between the United States and a lessee resulting from administrative or judicial litigation, or any coal lease subject to the requirements of this subpart, are inconsistent with any regulation in this subpart then the statute, lease provision, or settlement shall govern to the extent of that inconsistency.

(c) All royalty payments made to the Mineral Management Service (MMS) are subject to later audit and adjustment.

[54 FR 1523, Jan. 13, 1989, as amended at 61 FR 5479, Feb. 12, 1996]

#### § 206.251 Definitions.

*Ad valorem lease* means a lease where the royalty due to the lessor is based upon a percentage of the amount or value of the coal.

*Allowance* means a deduction used in determining value for royalty purposes. Coal washing allowance means an allowance for the reasonable, actual